C.D. Howe Institute
Commentary

C.D. Howe Institute

No. 27, January 1991 ISSN 0824-8001

Fiscal Policy

Strong Medicine:

Budgeting for Recession and Recovery

by

Irene K. Ip

The recession and other events have increased the fiscal year 1990/91 deficit beyond expectations, and only a heroic effort by the federal government will keep its red ink below $31 billion in 1991/92. But heroism is just what the times and the national financial plight call for.

The irresponsible bent of fiscal policy by Ottawa and the provinces has left both levels of governments without resources to cushion the blow of the recession. Though efforts to hold the line on deficits in line during an economic slump will be unpopular and will risk making the recession worse, they are needed to ensure sustainable, long-term economic growth.

The tax burden of Canadians has risen so far that further tax increases are no longer an option in cutting the deficit. A better way must be found to target expenditures — such as relating them not to GDP growth but to population growth and then adjusted for inflation. Each program must then be allocated to the right level of government, ordered according to national priorities, and aimed accurately at those for whom it was intended.

In fact, tackling the deficit, which is a national problem, will require bringing the provinces on-side. This will mean a redistribution of the revenue-raising and spending responsibilities of the federal and provincial governments by 1992. Fiscal arrangements can all be restructured within the existing Constitution and should not be left to muddy the more emotional constitutional issues that must be resolved later.

There is, however, a cure for Canada's fiscal ailment. If the federal government adopts a strategy for spending restraint along the lines that the C.D. Howe Institute suggests, a strong economic recovery in 1992 combined with an increase in revenues as a result of recent tax changes could cut the deficit by about a third in fiscal year 1992/93.

91-02226/

Introduction

Few forecasters expect Canada's current recession to be as deep as the one in 1981–82, but the prevailing policy mix runs the risk of making it last longer. Not only has monetary policy had to keep stamping on the smouldering embers of inflation while the economy has been getting weaker, but fiscal policy — particularly, but not exclusively, at the federal level — has had no choice but to be restrictive rather than expansionary.

The reason why Canada is not in good fiscal shape to deal with the current recession is that balancing budgets over the business cycle has not been a priority for either the federal or most provincial governments since the mid-1970s. At the federal level, the ratio of debt to gross domestic product (GDP), the best single indicator of fiscal prudence, was just shy of 55 percent at the beginning of the current fiscal year — almost double its level at the beginning of the previous recession. The aggregate net debt ratio of other levels of government (the provincial-local-hospital sector) also rose dramatically between 1981 and 1988; although it declined in the following two years, the reduction was too small and too late to turn the entire public debt ratio around. The experience of the 1980s suggests that there is a high risk of a further ratcheting up of net debt-to-GDP ratios in the wake of the current recession if preventive action is not taken immediately.

Many economists, including those at the C.D. Howe Institute, have warned repeatedly that if debt burdens were not brought down before the expansion began to run out of steam, governments would lose their ability to support the economy in a slowdown or recession. Now that the country is in the midst of recession, neither the federal government nor most provincial governments have room even to permit the *automatic* response of revenues and expenditures fully to take place.

Just as dallying over deficit reduction helped to make the expansion even stronger — pushing growth beyond a sustainable pace and making a correction inevitable — the fiscal straitjacket in which governments now find themselves is forcing them to make the downturn worse as they try to hold the line on deficits. In other words, Canadian fiscal policy has become destabilizing, increasing the risk of booms and busts.

The purpose of this *Commentary* is to present a possible approach to getting the public sector's net debt ratio turned around and onto a sustainable downward track over the next five years. It also addresses the problem of the federal government's responsibility for stabilization. The suggested strategy rules out further tax increases, other than temporary hikes in unemployment insurance (UI) premiums. Instead, it focuses on targeting a lower level of constant dollar expenditures per capita on key federal-only programs, as well as a redistribution of the revenue-raising and spending responsibilities of the federal and provincial governments.

Changes in the area of federal-provincial fiscal arrangements should accomplish two goals. First, they should bring the provinces on side in getting control of the federal financial situation, which is a national responsibility. Second, they should make it easier for the current debate about Canada's future to concentrate on the problems that really do need to be solved through constitutional change. Fiscal arrangements can all be restructured within the existing constitution; they should not be left to muddy the more emotional issues that must be resolved later.

The Changed Environment in 1990/91

In November 1990, Finance Minister Michael Wilson announced that his estimate of the federal deficit in fiscal year 1990/91 had been revised upward from $28.5 billion. This was not unexpected — the Institute, along with many other analysts, had pointed out that the Finance Department's over-optimistic forecast of interest rates in February 1990 made the estimate of debt service the riskiest component

Table 1

Baseline Assumptions about Canada's Main Economic Indicators, 1989–96
(annual percentage change, unless otherwise noted)

	1989	1990	1991	1992	average 1993–96
Real gross domestic product (GDP)	3.0%	0.9%	0.4%	3.3%	3.7%
Employment	2.0	0.7	–0.7	1.9	2.2
Unemployment rate (% level)	7.5	8.1	9.7	9.1	7.4
Inflation (Consumer Price Index)	5.0	4.8	5.5	3.2	2.4
90-day commercial paper rate (% level)	12.2	12.9	9.5	7.5	6.5
GDP deflator	4.9	3.2	3.8	3.2	2.4

Note: Figures for 1989 are actual; GDP and CPI data for 1990 are estimates. These figures are intended to illustrate the general economic environment in which the proposals in this *Commentary* have been framed. They should not be interpreted as a forecast.

Sources: Bank of Canada; Statistics Canada; C.D. Howe Institute.

of the budget projection. That interest payments were revised up by $2.5 billion was, therefore, hardly news. What was surprising was the finance minister's confidence that the deficit could be held down to $30 billion. Such an achievement would be quite remarkable given the change in the economic environment since February: record losses by the Canadian Wheat Board; higher interest rates; extraordinary expenses incurred as a result of the Middle East and Oka crises; and the onset of recession. The unexpected demands on federal resources are to be met by the "usual supplementary estimates," which draw on the unallocated funds that are part of every budget estimate (reserves) and by offsetting savings in other areas. But the trump card in the government's fall revisions, which kept the new deficit estimate from being even higher, was the remarkable growth in UI premium revenues, which the Institute estimates will be about $1 billion more than forecast.

Another Setback in 1991/92

The changed outlook for 1991 will, on balance, cause the 1991/92 deficit to veer even further off target. Instead of the $26.8 billion forecast in February 1990, the deficit is likely to come in between an optimistic $31 billion, if the Institute's recommendations are followed, and a pessimistic $34 billion, if the finance minister sticks to his current plan and an economic recovery gets under way by the middle of 1991. Of course, if the recession is longer than we have assumed or if the Gulf War drags on, both the optimistic and pessimistic deficits would be exceeded. Table 1 shows the Institute's assumptions concerning main economic indicators over the 1991–96 period.

In simple terms, the changed 1991 economic outlook will affect the 1991/92 fiscal projections as follows:

- The second year of real GDP growth below the budget forecast — less than 1 percent versus a forecast 3 percent — will depress revenue growth and increase expenditures.
- Somewhat higher inflation will raise the cost of some programs, such as Old Age Security and veterans' allowances, but there will be no compensating boost to revenues. For example, because the inflation rate is already over 3 percent, a further increase does not add to the personal income taxation windfall that partial indexation brings to the government (see Box 1).
- The recession is likely to help fulfill the government's forecast of short-term interest

Box 1

How Inflation and Indexation Affect Personal Income Tax Revenues

In a progressive tax system and a zero-inflation economy, when incomes increase, revenues increase more; when incomes decrease, revenues decrease more. The impact on tax revenues of an inflationary increase in incomes will, however, depend on whether or not, and how, the tax system is adjusted for the annual change in inflation. The greater the progressivity in the tax brackets, the greater the "bracket creep". The examples here use the present three-bracket system. The first example shows how the share of income going in federal personal income tax (PIT) — the effective tax rate — increases with a real income rise when there is no inflation:

Zero inflation			
Real income change	0.0%	2.0%	-1.0%
	Effective tax rate		
Initial year	19.0	19.0	19.0
Following year	19.0	19.1	18.9

Note: This example uses a person with $50,000 income and only the basic tax credit.

When inflation is present, but the tax brackets and credits of the PIT are not indexed, the federal government's PIT revenues increase more than proportionately. On the other hand, full indexation maintains the same proportion when there is no increase in real income. From 1974 to 1985, the government indexed the tax brackets and major allowances by a factor based on the Consumer Price Index (CPI), but the indexation factor was limited to 6 percent in 1983 and to 5 percent in 1984. Since 1986, indexation has been restricted to changes in the CPI, in excess of 3 percent. Therefore, the government's taxation windfall is maximized when inflation is at 3 percent.

The second example builds in an annual inflation rate of 5 percent and an increase in income that only compensates for inflation — that is, no real increase. It illustrates the impact of various indexation formulas on the effective rate of federal personal income tax:

Income levels	$25,000	$50,000	$100,000
	Effective tax rate		
Initial year	12.9%	19.0%	23.9%
Following year			
Case 1:			
Full indexation	12.9	19.0	23.9
Case 2:			
Indexation for inflation above 3%*	13.0	19.2	24.0
Case 3:			
No indexation	13.1	19.3	24.1

* Effective rate is same for any inflation higher than 3 percent.

rates that will be 160 basis points lower in 1991, enabling debt-service charges to rise only marginally in 1991/92.

The government's own sensitivity analysis, applied to the Institute's economic assumptions, suggests that the 1991/92 deficit would rise by $4.2 billion over the February 1990 estimate of $26.8 billion, without taking into account the impact of the recession on UI payments and premium revenues. (The government provides no sensitivity analysis for UI or for a change in inflation.) The Institute estimates that the UI shortfall (premiums minus benefits) for 1991/92 will be about $2.5 billion higher than the government estimated, which would make the total budgetary deficit between $33 and $34 billion.

Why the Deficit Is a Problem

Why is it so important to hold the line on the deficit in the middle of a recession and to act now to make sure that there is a major reduction as soon as the recovery begins? There are three main reasons.

First, the public sector was responsible for the decline in the national saving rate during the expansion of the 1980s. The result was a growing reliance on international funds, and the servicing of that foreign debt grew to 3 per-

cent of GDP in 1990 from 2 percent in 1980. Although the private sector's demand for funds typically falls in a recession — and thus foreign borrowing might be reduced over the next few quarters — once the recovery gets under way, there is a danger that Canada will again depend heavily on external borrowing. With much fiercer competition from other international borrowers in the 1990s, Canadian interest rates would need to remain ever higher against those of the rest of the world.

Second, deficits that are incurred to finance current goods and services, rather than investment, leave citizens with an unrealistic picture of the cost of those goods and services. A protracted delay in bringing expenditures into line with revenues will risk entrenching a level of services that cannot be paid for with a tax burden that the public will accept. Cutting back or eliminating many programs then becomes political anathema, while an increase in taxes pushes economic activity out of the official economy into a growing underground sector, or beyond the country's borders, or out of existence altogether, with the obvious detrimental effects on fiscal health and on the economic well-being of individuals.

Third, chronic deficits during expansions become fiscal crises during recessions, running the risk of triggering procyclical fiscal policy. For example, the UI balance ideally should have gone into deficit in 1990. Instead, because of the need to reduce the deficit, the government introduced changes in 1989 that caused it to post a surplus through higher premiums in 1990.

The detrimental effects of public sector deficits and debt on Canada's long-term economic prospects make it necessary to get the deficit and debt ratio back onto a firm downward track in spite of the recession.

The Weakness in the Government's Strategy

It would be a mistake to dwell too heavily on the events that have conspired to knock the deficit plan off track. Every finance minister faces such risks when making a budget projection, and every student of fiscal policy understands and accepts certain setbacks. The real problem has been the regular recurrence of these setbacks. The government has failed to put in place a tough medium-term deficit-reduction strategy to turn the debt-to-GDP ratio around.

Such a strategy, as the Institute has pointed out on many occasions, would need to make substantial cuts in the first year in order to take advantage of the compounding benefits to the debt-servicing burden. For example, a $1 billion cut in spending for 1984/85 would have saved a similar amount in debt service by 1991/92. The failure to bite the bullet on deficit reduction early on in the expansion has left the government with no fiscal flexibility to soften the impact of the recession.

The net federal debt is now so large that the government has no choice but to offset the increases in nondiscretionary expenditures — such as interest payments — and the weakness in revenue growth with discretionary fiscal action. Concrete examples already exist of how fiscal policy is being constrained. Even as the economy was running out of steam in 1989, legislation was introduced that raised UI premiums by more than 15 percent beginning on January 1, 1990. Later, in the February 1990 budget, when the risk of recession was increasing, welfare assistance cost sharing with the three wealthiest provinces was capped, starting in April 1990.

The lack of credibility and staying power of the government's deficit-reduction plan lies in the fact that it has relied too heavily on temporary and arbitrary spending freezes, as well as on devices such as the acceleration of tax remittances. Instead, it should have tackled program objectives and priorities head on in order to make expenditure control the keystone of deficit reduction. As recently as February 1990, the government resorted once again to such stop-gap measures as "temporary" across-the-board control of spending growth. Programs that were easy targets — because they were new and not broadly "popular" — such as the Canadian Exploration

Incentive Program and the Other Six Leases Operations project, were cut. The more challenging job of excising those longer-term programs that were low priority or no longer fulfilling a national goal was postponed again.

Another problem with the government's medium-term deficit-reduction strategy has been its repeated recourse to tax increases in the 1980s, when provincial governments were also raising taxes. There was no effort to cooperate with the provinces in order to ensure that the combined tax rates did not rise too far. Rather, the decade was characterized by a mood of one level of government trying to outmaneuver the other.[1]

There were good reasons for the federal government to have increased its tax share at the expense of the provinces during the expansion of the 1980s. It had, after all, borne the brunt of supporting the national economy during the 1981–82 recession, and had come to the aid of individual provinces in times of crises (agriculture, energy, financial, fisheries). However, such action needed to be undertaken with the promise of provincial support in dealing with the added strain on federal finances. Instead, the country is now laboring under a tax burden that threatens to damage its economic prospects.

A Medium-Term Plan to Control Deficits and Debt

In its *Policy Review and Outlook, 1990*, the Institute laid out what — in its opinion — was a reasonable plan for dealing with the debt problem. We suggested two possible strategies for bringing down the net debt-to-GDP ratio over the medium term, and we pointed to several specific areas where we felt cuts could be achieved.[2]

After the initial reduction in the deficit in 1990/91 to around $26 billion, the plan incorporated an average reduction of $5 billion a year over the following four years. Whereas last year the Institute advocated some revenue enhancement, we no longer feel that higher taxes are a viable option for dealing with deficits and debt. Tax increases should be introduced only for *very temporary* financing of an extraordinary and *temporary* expenditure. We retain the basic emphasis on reordering priorities in programs and on facing the need to drastically restructure some. Here, we want to re-emphasize the importance of a multiyear deficit-reduction strategy, with the reduction over the next five years averaging close to $5 billion a year (see Table 2).

Recognizing that the government's April 1989 plan had already been negatively affected by the replacement of the federal sales tax (FST) with the goods and services tax (GST) and by higher interest rates, the Institute proposed in 1990 that the government target a deficit in the region of $26 to $26.5 billion for 1990/91. At the time, we also recommended that any slippage as a result of a slowdown or recession be treated as a setback to be made good later. In making this recommendation, we assumed that the government would adopt our target, and we recognized that it would be politically unrealistic for the government to reduce the absolute level of the deficit during a recession.

It is now obvious that it will be very difficult to budget for a deficit that is the same size in 1991/92 as in 1990/91. It will, in fact, require an extraordinary effort and commitment by the federal government to keep the 1991/92 deficit below $31 billion. The struggle would be worthwhile, however, in that the recovery would not be hampered by a renewed fierce competition between the private and public sectors for domestic savings, which would drive interest rates higher once again.

In 1992/93 — assumed to be the first year of renewed expansion — it should be possible to carve about $9 billion off the main budget deficit (excluding the UI account), leaving it at $17.5 billion and achieving a reduction in the net debt-to-GDP ratio. This somewhat surprising prediction assumes healthy economic growth in 1992, strong revenue growth — the grounds for which have already been laid — falling interest rates, and new program cuts as advocated in this *Commentary*. Briefly, the

Table 2

The Federal Government's Budgetary Transactions, fiscal years 1989/90 to 1995/96

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
				($ billions)			
Budgetary revenues	$113.7	$118.8	$123.8	$135.2	$146.0	$152.8	$157.3
Budgetary expenditures	142.7	148.8	154.6	154.5	157.3	159.9	163.4
Program expenditures	103.9	105.1	111.8	111.8	114.5	117.7	121.7
Public debt charges	38.8	43.7	42.8	42.7	42.8	42.2	41.8
Budgetary balance	(29.0)	(30.0)	(30.8)	(19.3)	(11.4)	(7.1)	(6.1)
Main budget balance	(30.0)	(30.1)	(26.4)	(17.4)	(13.0)	(10.0)	(7.2)
UI account balance	1.0	0.1	(4.4)	(1.9)	1.6	2.9	1.1
Net public debt	358.0	387.9	418.7	438.0	449.4	456.4	462.6
				(as a percentage of GDP)			
Budgetary revenues	17.5%	17.5%	17.5%	17.9%	17.9%	17.7%	17.3%
Budgetary expenditures	21.9	21.9	21.8	20.5	19.3	18.5	18.0
Program expenditures	15.9	15.5	15.8	14.8	14.1	13.7	13.4
Public debt charges	6.0	6.4	6.0	5.7	5.3	4.9	4.6
Budgetary balance	–4.4	–4.4	–4.3	–2.6	–1.4	–0.8	–0.7
Net public debt	54.9	57.2	59.2	58.1	55.2	52.9	50.9

Note: The table illustrates the outcome for the deficit based on the assumptions presented in Table 1 and the C.D. Howe Institute's recommended spending strategy. The main budget is the budgetary balance minus the UI account balance. Data for 1989/90 are actual; data for 1990/91 are estimated; data for all other years are forecast.

Sources: For 1989/90, Receiver General for Canada, *Public Accounts of Canada 1990*, vol. 1 (Ottawa: Supply and Services Canada, 1990); all other data are C.D. Howe Institute estimates.

factors that should help the deficit to fall are as follows:

- the economy is likely to be expanding strongly in 1992;
- revenues from the GST will be free of transitional costs by 1992/93 (around $2 billion a year in 1990/91 and 1991/92);
- the shortfall of UI premium revenues from benefits could decline to an estimated $0.5 billion — a $3 billion improvement over 1991/92;
- benefits from the Bank of Canada's anti-inflation stance should become even more evident in 1992/93 in the form of lower interest rates;
- changes in the tax structure, which were introduced in the 1980s, have increased the elasticity of revenues and will exert considerable force on revenue growth in the recovery and expansion (the Finance Department predicted that these measures would increase its budgetary revenue to 18 percent of GDP by 1993/94 from 15.9 percent in 1984/85);[3] and
- a strategy of medium-term program spending restraint, as advocated in this *Commentary*, should be under way.

By 1995/96, we estimate that UI premiums would be set to yield a $1 billion surplus in the UI account, while the main budget deficit — the total minus the UI account balance — should have been cut to about $7 billion (see Table 2).

In summary, the main budget cuts should be planned to average about $4.5 billion a year from 1991/92 to 1995/96 inclusive. We have assumed that UI premiums after 1992 will be set to pay off the outstanding UI account debt by 1995/96 (the longer timetable is a function of the three-year premium freeze). In this framework, the aggregate budget deficit in 1991/92 rises by $1 billion from the 1990/91 level, but falls by over $11 billion in 1992/93 and a further $13 billion over the remaining three years of the plan. The net debt-to-GDP ratio peaks in 1991/92 as the government planned in February 1990 (see Figure 1).

The Institute recommends that the restrictions to program growth — other than UI — suggested in its *Policy Review and Outlook, 1990* be adhered to, regardless of the performance of the economy. This is because the restraint program we support is an overall plan that aims to control expenditure growth and the debt burden over the long term, and cannot be allowed to be put on the back burner until the time is "right". The federal government needs to act now to get its expenditures onto a sustainable, lower-growth path by the mid-1990s.

The Problem of Stabilization

Nevertheless, long-term fiscal planning does need to build in some flexibility to deal with cyclical fluctuations in the economy. Uncertainty about the length and depth of recessions and about the strength and timing of recoveries makes discretionary countercyclical fiscal action of questionable value. Furthermore, the federal government does not have a good record on this score. It is preferable to rely on the automatic stabilization role of fiscal policy; unfortunately, a number of developments have weakened this role in recent years (see Box 2).

Box 2

Automatic Stabilizers in the Federal Budget

A number of developments have weakened the sensitivity of federal revenues and expenditures to changes in output in recent years. The most important examples are the reduction of personal income tax progressivity and the reduction in tariffs under the General Agreement on Tariffs and Trade and the Canada-U.S. Free Trade Agreement. In 1991, the replacement of the federal manufacturers' sales tax by the goods and services tax will reinforce these developments.

We therefore suggest that, in order to make the federal budget balance stronger, the budget be separated into three sections:

- *the UI account*: its sensitivity to business cycles should be increased, and it should be the principal instrument of stabilization at the federal level;
- *the main budget*: this should contain non-UI ordinary expenditures; and
- *an extraordinary account*: special needs, such as the costs incurred in the Oka crisis and the Gulf War, should not be included with the main budget, and their method of financing should be made clear — for example, a temporary tax legislated at the time of the expenditure, with the end date being specified in the legislation.

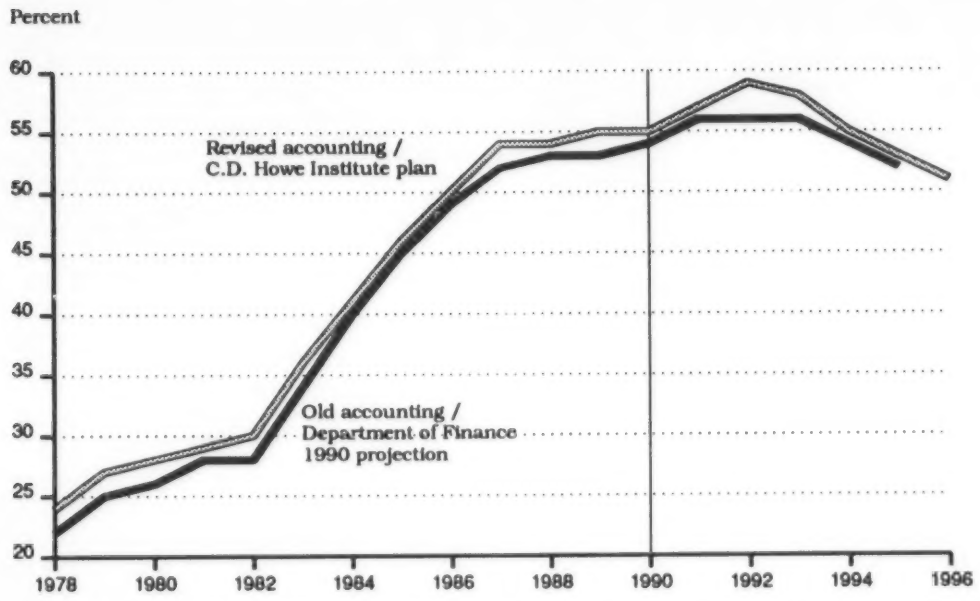
The UI Account

Legislation provides for the UI account to be balanced over time, permitting benefits to exceed the premium revenue in a slowdown or recession and the premiums to be raised in an expansion to pay off the accumulated deficit. In other words, the UI account's stabilizing role is rooted in the timing of this self-financing rule.[4] The UI commissioners previously used a formula to bring the account into balance over three years, but for some time the finance minister has had discretionary power to override the automatic premium adjust-

Figure 1

Net Federal Government Debt, fiscal years 1977/78 to 1995/96

(as a percentage of Gross Domestic Product)



Note: The federal government changed its accounting method in 1990 and released revised data with the 1989–90 Public Accounts.

Source: Department of Finance; C.D. Howe Institute.

ments. In other words, he has been able to exercise a great deal of control over the size of the deficit or surplus and the speed with which the outstanding deficit is paid off.

The delay in adjusting the premium upwards in the 1980s dragged out the settling of the cumulative balance to the end of the decade, making the budgetary deficits and debt worse. The minister's discretion appears to have been temporarily overridden by recent legislation that froze the premium at $2.25 for the 1990–92 period (see Box 3).[5] In retrospect, this action was most inappropriate, because the premium is too high for the recessionary quarters and will be too low once the expansion is under way in 1992 to reduce the accumulated debt significantly. Thus, it seems inevitable that there will be a massive increase in the premium rate in 1993.

In our opinion, the stabilization function of the UI account is too important to be left to the whims of finance ministers. In addition to premium changes being made automatic once again, the sensitivity of the account to business cycles should be enhanced. We suggest, therefore, that the changes to the premiums be indexed to the unemployment rate, so that in down-times disposable incomes of the employed are increased to stimulate spending, and vice versa in a recovery. At the same time, some of the burden of repayment of recession benefits would come back onto those recipients who eventually are re-employed. The formula could even be differentiated by region. The formula-driven payments for retraining should also be immune from the finance minister's override.

One formula that could be used to set the premium is a 10 cent change from a base rate for a 1 percent change in the unemployment rate (also from a base), which should be adequate to balance the account over a reasonable period. Such a formula, however, would have to include a ceiling on the premium so that, in

Box 3

The Unemployment Insurance Program

On June 1, 1989, the federal government introduced legislation, Bill C-21, to restructure the unemployment insurance (UI) program, intending it to go into effect on January 1, 1990. The bill did not, however, receive Royal Asset until November 1990, and between January and November, UI was operating under a combination of old and new rules. Under the old legislation, the program was funded in two parts:

- regional extended and fishermen's benefits, in excess of the premiums they paid, and extended benefits to claimants undertaking approved training or participating in job-creation projects, were financed out of general revenues;
- the remaining costs of the program, including the administration of the fund and the appropriate amount for debt service, were financed by employer-employee premiums.

Under the new legislation, all benefits are to be funded by employer-employee premiums. To this end, the premium rate for employees was raised to $2.25 per $100 of insurable earnings for 1990 to 1992.

Although the bill had not been passed, practically all employers remitted the premiums at the new rate from January, 1, 1990. The government continued, however, to make contributions to the account for the cost of part 1 benefits until the bill was passed. Consequently, the account appears to have gone into surplus in calendar year 1990.

The major changes in Bill C-21 that will affect the expenditures of the UI account only went into force in November 1990, and are as follows:

- the number of weeks worked in order to become eligible for benefits has been increased; only when the regional unemployment rate is over 15 percent (previously 9 percent) does a claimant need just ten weeks of work to qualify; as the regional unemployment rate gets closer to 6 percent, the required number of weeks of work to qualify rises to 19;*
- the maximum number of weeks of benefits has been reduced to 50 from 52; this maximum is only paid in regions where the unemployment rate exceeds 10 percent;
- maternity benefits may be claimed for 25 weeks instead of 15; and
- the number of years for which retraining allowances can be given has been extended to three; retraining costs up to the equivalent of 15 percent of the income-mainenance benefits may be financed by the UI account (this is part of the new Labour Force Strategy).

The first two of these changes will reduce total costs, while the latter two will increase costs. It is not yet clear if the two effects will balance out over time.

* The effect of the legislation is to reduce the number of regions that will qualify for the ten-week rule, particularly during a recession (see Statistics Canada, *The Labour Force*, Cat. no. 71-001 (November 1990), Table 39).

the event of a prolonged boom, the account did not keep amassing revenues that might be directed to purposes inconsistent with the spirit of the UI legislation.

The Main Budget

It may be trite to repeat, but there will be only two choices to deal with the next round of deficit and debt problems — tax increases or program cuts. The odds, unfortunately, appear to favor tax increases. In view of the propensity of governments to take advantage of clandestine revenue enhancers (such as inflation) and of taxes with obscure incidence (such as payroll taxes), it is necessary to stress here the inherent dangers of a further increase in the tax burden and the need to put into place a medium-term, sustainable expenditure-control plan to keep the main budget deficit falling steadily over the next five years.

The Tax Burden

Canada's tax burden is about average among the major industrialized countries. It shows up

in the ratio of total government revenues to GDP, which, by 1989, had surpassed 39 percent.[6] The magnitude of such a tax burden can have a negative impact on a country's growth prospects, in the following ways:

- business relocates its operations, or does not start up, or does not expand;
- individuals reduce their work effort and are discouraged from investing in further education or training to raise their long-term, before-tax earning potential; and
- consumers shift some of their consumption to neighboring, lower-tax jurisdictions, while foreign tourism is discouraged.[7]

High effective and marginal tax rates also encourage the substitution of nonmeasured activities — such as barter, under-the-table dealings and so on — for measured activities.

Distortions can be removed from the tax system to raise potential output — for example, the replacement of the FST with the GST, removes such a distortion. However, if the average burden is still too high and expected to rise further — for example, there is a broadly based conviction that the GST will soon be increased in order to reduce the federal deficit — then the economic benefits may be short-lived.

Tax Limits

Governments generally realize that the effective rate of tax cannot be raised indefinitely without seriously discouraging growth prospects, but there is no hard evidence that a tax limit exists, let alone a formula to pinpoint it. Is there an invisible ceiling — say, somewhere between 40 percent and 100 percent — that the economy suddenly hits and to which it then reacts adversely? If so, has this limit shifted over time? Does it vary from country to country? These are interesting questions to which no one has yet provided answers.

A quick review of the changes in the rates of growth of taxes in the industrialized countries over a number of years suggests that the negative effects of relatively low tax burdens — up to about 30 percent of GDP — are insignificant. Beyond this level, the costs of risk taking become increasingly more prohibitive, the costs and benefits of making purchases from another jurisdiction surpass the breakeven point more frequently, and the closedown and startup costs of transferring a business to a lower-tax country become worthwhile. In addition, the risks and costs of evasion and avoidance, both of which may have a fixed-cost element, begin to be more and more rapidly outweighed by the benefits. However, because there are so many other factors influencing the rate of growth of the economy at one time, it may not be obvious until the tax share of GDP goes over 50 percent that the tax increase has become counterproductive.

During the 1970s, many European countries — including West Germany, France, Belgium, and Austria — taxed a much higher share of national income than did the United States, yet they had higher per capita growth rates than the United States, and almost the same as Canada. This appeared to disprove theories of negative effects of a high tax rate on private production.[8] (It must have been particularly comforting for the Canadian federal government that, in spite of a higher tax rate than the United States, Canada's per capita growth was twice as great.)

Of course, fiscal policy was only one factor among many at work. Countries that were members of the European Community (EC) were reaping the benefits of an enlarged goods market. Norway and the United Kingdom were beneficiaries of North Sea oil, while Switzerland, having cut itself off from the trade gains of EC membership, had below-average real GDP growth in spite of its low tax rate.

Nevertheless, there was already some evidence of a link between high tax burdens and real economic growth in the cases of Sweden, Denmark, and the Netherlands. The tax share of national income in these countries was over 45 percent, higher than the shares in West Germany, France, Austria, and Belgium, and per capita growth was lower. By the 1980s, the

latter four countries also had tax rates of 45 percent or over, and output growth rates that were closer to those of Sweden, Denmark, and the Netherlands.

One may deduce from recent moves to reduce the tax burden in Denmark and Sweden that the governments of these countries believe that they have reached some kind of limit. This might be described as a tax rate that, in the long term, gets so close to one-half or more of the national income (depending on the country) that it will eventually discourage a significant amount of domestic economic activity.

Although the correlation between the tax rate and per capita growth is somewhat tenuous, it appears costly for governments to allow expenditures to get so large that almost one-half of national income must be taxed away to pay for them. In fact, it is probably wiser to start to constrain the nation's appetite for government-delivered services once the effective tax rate exceeds 40 percent, because of the high probability of a negative effect on the country's economic growth.

In Canada's case, total government revenues would have had to be over 43 percent of GDP in 1989 simply to bring them into line with current expenditures — a level that the Institute considers to be in a danger zone. If expenditures are not restrained significantly, governments may have to resort to further tax increases to achieve an adequate reduction in the deficit over the medium term. In some provinces, combined federal and provincial effective tax rates have already reached 40 percent, yet deficits remain. Governments at all levels in Canada should be wary of trying to increase the tax burden further.

A Strategy for Expenditure Control

The federal government now has really no choice but to make further substantial program cuts. The problem it faces in bringing the debt burden under control was cogently put by the Department of Finance as part of its 1986 budgetary presentation:

> In a situation where real interest rates continuously exceed real economic growth the fiscal situation is potentially explosive. In such circumstances debt and interest payments as proportions of GNP [sic] rise without limit. The only recourse for the government is to take corrective action to reduce program expenditures and/or increase revenues. Moreover, the size of the corrective fiscal policy action needed is related directly to both the size of the debt-to-GNP ratio and the differential between real interest rates and real GNP growth.[9]

Real short-term interest rates exceeded real GDP growth in 1986, 1988, 1989, and 1990, and are expected to continue to do so in most years to 1996, with the largest differentials coming in 1991 and 1992.[10] For this reason, it is important to initiate program cutbacks immediately.

A lamentable development in fiscal policy targeting took place in the 1980s. Program expenditures versus revenues became the focus of attention, and a decline in the ratio of program spending to GDP and a surplus on the so-called operating budget was considered to be an indication of responsible fiscal policy. While the separation of program spending and debt service serves a useful purpose to draw attention to the way the debt burden squeezes the growth of program spending, the path of program spending on its own is irrelevant for fiscal prudence.

When governments cling to deficit financing as a way of fiscal life, they do so in the awareness that they are borrowing from the future for higher spending than voters are willing to pay for in the present, but that sooner or later the debt service will have to be factored into the budget strategy. Certainly during a recession, there is general support for borrowing from the brighter future. In both cases, however, those borrowing costs must be dealt with eventually by a bigger tax bite or some program cutbacks, not by yet more borrowing. A decline in program expenditures relative to GDP or budgetary revenues may not get the net debt ratio onto a downward track if the savings are constantly being eaten away by higher debt-service costs. By setting up

program expenditures and operating budgets as targets of prudent fiscal policy, governments perpetuate the myth of the free lunch, and make it harder to tackle a radical reordering of priorities.

Once the government has set out on a path of expenditure restraint, it will have to use some measurement concept to guide its strategy of program reductions and to explain its plans and achievements to the public. Various measures are available for such purposes, but many do not clarify strategy and some are even misleading.

One statistic used is the rate of change of spending or revenues, either from a previous base year or over the medium term. In the former case, the choice of the base year can favorably influence the rate of change; in both cases, the inflation component of the growth rate renders the statistic virtually meaningless. Only rarely are growth rates given in constant dollar terms.

Governments also relate their spending, revenues, and deficits to GDP — reducing, but not eliminating, the inflation problem.[11] Ratios to GDP can, however, be dangerous and deluding guidelines.[12] Concentrating on a stable expenditure ratio may give a government a "license" to allow spending to grow rapidly during years of unusually buoyant growth. (Stable expenditure ratios as a guide for fiscal policy were deplored by the present federal government.)[13] But declining ratios, which have been embodied in the present government's medium-term fiscal plans, may not be a reliable indicator of prudent fiscal policy either.[14] During a boom period, even a declining ratio of spending to GDP may translate into overly strong increases in outlays. Once the economy enters a period of declining, stagnant, or generally poorer growth, revenue will grow more slowly, while the built-in spending momentum causes a rising shortfall. Alternatively, after years of uncontrolled spending, a medium-term, moderate decline in the spending-to-GDP ratio may bring expenditures into line with revenues too slowly.

It would be more responsible to target constant dollar spending per capita. Although there might be very good and public reasons for growth in this measure, there has been no effort to explain its strong gains over the past two decades as shown in Figure 2.

This *Commentary* proposes a two-stage plan to get expenditures back onto a sustainable long-term growth path.

Stage One involves, first, the selection of an earlier period's constant dollar per capita level for each of four categories as a target to be reached over the next four years. It is then necessary to re-evaluate existing programs and to reorder program priorities to determine how the targets might be achieved.

Stage Two tackles the federal government's deficit from a truly federal perspective, recognizing that the provincial governments bear some responsibility for the state of the federal finances and therefore have an active role to play in the solution. This second stage would take longer to implement, of course, because of the need to renegotiate the fiscal arrangements with the provinces.

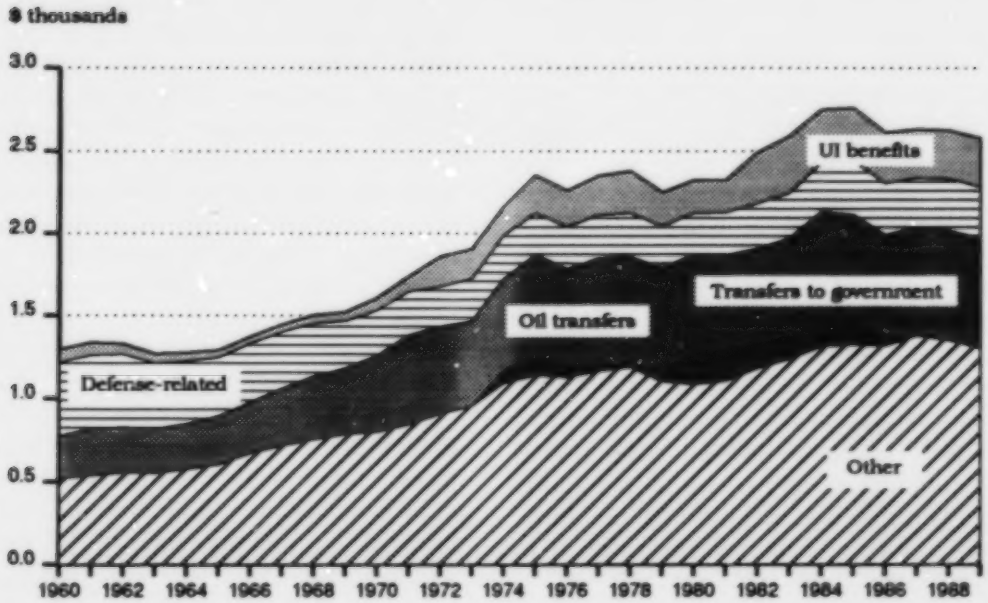
Stage One: Setting Targets and Priorities

Programs at both levels of government are generally set up in an uncoordinated manner and are carried out by means of direct expenditures, tax expenditures, or through government and quasi-government agencies or other levels of government. It is, therefore, very difficult to match total cost with policy objectives.

The federal government's objectives might be seen in three broad groups:

- income distribution;
- federal-provincial cost-shared public goods or services that benefit residents in other provinces to a significant extent; and
- national public goods such as defense, justice, and institutions that strengthen national unity.

Figure 2
The Federal Government's Program Expenditures, 1960–89
(thousands of 1981 constant dollars per capita)



Note: Oil transfers consist of Petroleul Compensation and Petroleum Incentives Programs only.
Source: C.D. Howe Institute calculations, based on Statistics Canada data.

Without a detailed breakdown of all program expenditures by economic category and the dollar value of tax expenditure components of these programs, the analysis presented here is necessarily incomplete. However, the point to be made is that the federal government should concentrate on ending its financing of those programs that clearly fail to fit in one of the above groups and on restructuring those programs that are not appropriately targeted. In this way, the government should be able to sufficiently restrain the current dollar growth of program expenditure, so that debt service and program spending combined — excluding UI — are under control.

We have excluded some programs from this first stage of setting spending targets. First, the government's long-term plan for defense has already been modified as part of its deficit-reduction strategy. Recent events at home and abroad suggest that this may not be the right time for further action in this area. Second, there is also a long-term target for Overseas Development Assistance, which, in fact, is a commitment that Canada has broken continuously for years.[15] Third, payments to veterans and their families are firm commitments that cannot be broken. Finally, transfers to governments are dealt with in Stage Two. The remaining programs — the "other" category shown in Figure 2 — are examined here according to four categories that conform to Statistics Canada's National Income and Expenditure Accounts (NIEA) presentation:[16]

- the nondefense consumption of goods and services;
- fixed capital;
- transfers to persons, excluding UI benefits and veterans' allowances; and
- transfers to business.[17]

Nondefense Consumption

Wages, salaries, and supplementary benefits of civil servants account for about 80 percent of this category. The remainder comprises office overheads, contracted-out services, and repair and maintenance of buildings.

The Civil Service

Last year, Finance Minister Wilson drew attention to the fact that the civil service was the same size in 1990/91 as it was in 1973 — a substantial decline in staff relative to population. But why should he have chosen 1973 as a benchmark in the first place? Government functions change; in a federal system, they may be shifted to another level of government and in some areas, such as revenue collection, there ought to be enormous economies of scale and productivity increases due to advanced technology.

The 1973 level was only reached after a decade or more of substantial increases. In the second half of the 1960s, there was a substantial restructuring of the federal government machine. New departments were created, including the Office of the Treasury Board, Supply and Services, Communications, and Consumer and Corporate Affairs, while Mines and Technical Surveys was expanded to Energy, Mines and Resources. These and other changes contributed to a large increase in the number of federal civilian public employees as a share of the total population from 1965 to 1970.

Another large increase took place from 1970 to 1974, but many of the programs introduced in the 1970s have since been eliminated or reduced in importance. Energy, Mines and Resources became a growth area in the 1970s, for example, but has now been drastically cut back. Manpower and housing programs also proliferated in the 1970s, but manpower policies have changed and the federal role in housing has been reduced.

It is hard to determine if, on balance, Canada needs as large a civil service today as it had in 1973. It is certainly true that there has been significant growth in the number of civil servants who are concerned with management, rather than with program delivery.

Bearing in mind that the available information on the size of the civil service does not make it easy for analysts outside the government to evaluate developments and trends accurately,[18] we can compare the changes in person years (PYs) — as included in various federal government Estimates — between 1970 and 1990. In 1990 the PYs for what might be called "management" departments — Revenue, Finance, Supply and Services, the Treasury Board, and the Privy Council — were almost 50 percent higher than in 1970/71, whereas the country's population rose by only 23 percent in the same period. Revenue alone needed an increase of almost 80 percent (from about 18,000 to almost 32,000) for administration and enforcement — one of the costs of an increasingly complex and burdensome tax system. There is no end in sight to this growth. For instance, the Auditor General has expressed concern that although the number of PYs used for enforcement increased between 1984/85 and 1989/90, enforcement actually declined.[19] Furthermore, the federal government has estimated that the administration of the mature GST system will cost $380 million in 1992/93.

In the area of service delivery (all other departments combined), there are many examples of major staff reductions since 1970. Cutbacks in Public Works and in Energy, Mines and Resources were to be expected, but a reduction in the staff level of the National Research Council is unreasonable if Canada is really committed to basic research. On the other hand, the increases in some departments are so large as to defy explanation, considering the level of service they deliver. For example, Employment and Immigration had 24,362 PYs in 1990/91, which is 56 percent higher than the combined operations of this department and the relevant part of Labour's 15,622 PYs in 1970/71. Veterans Affairs — a department that is in a sunset area — spent

$410 million in 1989/90 to deliver $1,283 million in pensions and allowances. A ratio of administration to transfer dollars of 1:3 surely needs further examination.

The cost of the federal civil service could also be reduced by eliminating duplicated administrative responsibility between the federal and provincial governments. A greater effort to reduce this type of unnecessary overhead would bring substantial savings to the operations of the federal government.

It seems clear from the growth of the federal civil service over the past two decades that to cut it back to its 1965 PY level would be to leave it too small for today's needs, but that its level of 1973 or 1974 would still be too large. About midway between the two should be an attainable target. We therefore propose using the level of 1970 as a target for real per capita expenditures on the civil service and for related expenditures on government operations.

Public Service Pensions

Another area where some savings should be found is in the cost of the public service pension fund. The government's contributions to the various superannuation funds are included in goods and services expenditures. The public service superannuation plan calls for the government to match both (a) the prior year's employee contribution of 6.5 percent of salary less contributions to the Canada Pension Plan and (b) 1.0 percent of salary for the full indexation of the pensions to the cost of living. (In addition, the government is responsible for the amortized actuarial deficiency of the funds, which are included in the NIEA category of transfers to persons.) The provisions of these plans, particularly for indexation, are a source of resentment in the private sector, where many employees are not covered by any form of employer plan.

Initially, the indexation factor for inflation should be reduced and the expected inflation rate that is used in the actuarial valuations of the fund should reflect the government's long-term commitment to price stability. Future contributions and annuities of the public service plan should be no better than those of an average private sector plan.[20] With regard to retirement provisions for Members of Parliament, substituting locked-in Registered Retirement Savings Plans for the present pension plan should be considered. Both the government and beneficiaries would contribute during the years of parliamentary service, but the government's obligations would end with the MP's departure.

Proposed Expenditure Target for Non-defense Consumption

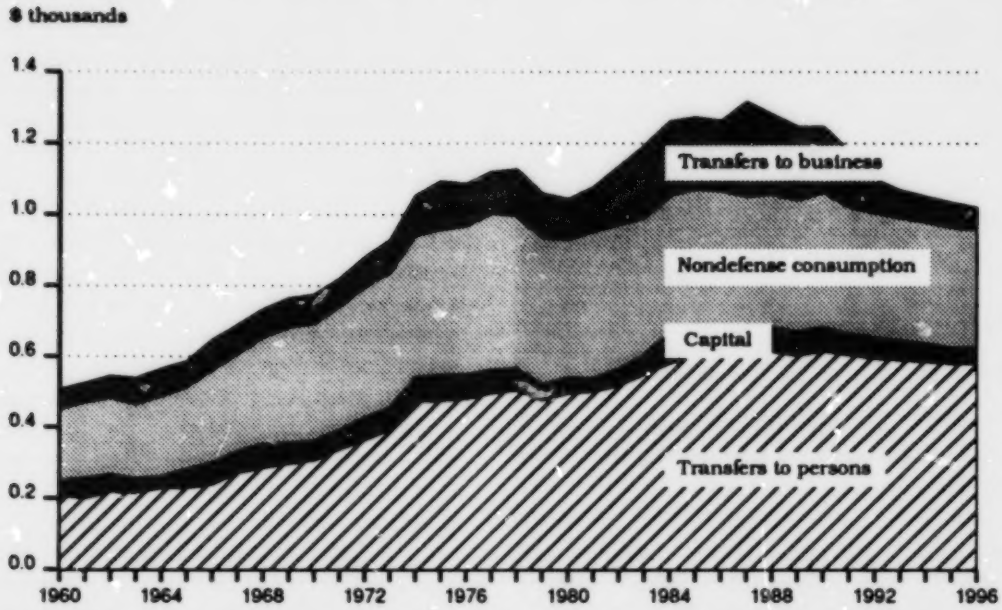
By 1995, the constant dollar per capita level of expenditures should be reduced to that of 1970 (see Figure 3). Under this proposal, the spending path — in current dollars — starts out with the same overall level of goods and services expenditures for 1991/92 that was targeted in the 1990 budget. By 1995/96, the current dollar level is expected to be about $2.2 billion less than it would be if the 1990 constant dollar per capita level had been maintained.

Capital Spending

Capital spending, as measured by the NIEA, is a relatively small area for the federal government. Nevertheless, its relative unimportance should make it one spending category that is relatively easy to control. Many projects are pure luxuries, and should not be undertaken when the debt burden is a problem. In addition, there is a tendency for federal capital projects — large and small — to have cost overruns.[21]

There is no reason why federal capital expenditures per capita (in constant dollars) should be larger in 1990 than they were in, say, 1982, which was a recession year. In fact, although capital spending has been an important component of discretionary countercyclical policy in the past, there are limited outlets at the federal level for direct capital construction. There is only so much that can be justifiably spent on federal office buildings, prisons, museums, and so forth, and most

Figure 3
Expenditures of Federal Government on Selected Programs, 1960–96
(thousands of 1981 constant dollars per capita)



Source: C.D. Howe Institute calculations and plan based on Statistics Canada data (see text for definitions).

stimuli must be applied through assistance to private and government enterprises and to provincial governments.

Proposed Expenditure Target for Capital Projects

By 1995, expenditures should be reduced to the point where they are simply maintaining the present capital stock. We estimate this to be the same constant dollar per capital level as in 1982 (see Figure 3). The reductions would be achieved gradually, with 1991/92 current dollar spending being kept on the 1990 budget target. We believe the saving would be $552–828 million in current dollars in 1995, compared with the maintenance of either 1990 or 1991 constant dollar per capita levels.

Transfers to Persons

Expenditures on transfers to persons, other than UI and veterans' allowances, have almost doubled since 1970 in constant dollars per capita.[22] The growth has occurred in payments to native people, Old Age Security (OAS), and in a proliferation of programs covering diverse goals. Constant dollar per capita spending could be rolled back to the 1984 level without jeopardizing the federal government's core social objectives.

On an NIEA-adjusted, current dollar basis, the total was about $37 billion in 1989/90.[23] Excluding UI benefits and veterans' support, however, the total was $24.1 billion.

Income Support

From Table 3, it is obvious that little progress can be made in the restraint of these transfers without including the more than 80 percent that is spent on income support. It is important to remember when considering these transfers that, from 1990 on in the case of higher-income individuals, both the OAS and the Family Allowance are subject to a recap-

Table 3

Federal Government Transfers to Persons, fiscal year 1989/90

($ billions)

Type of Transfer	Amount
Income support	
Indexation of retired government employees' pensions	$1.0
Old Age Security	16.2
Family Allowances	2.7
Total income support	*19.8*
Other transfers	
Payments to native people and associations	1.9
Research, education, training	1.6
Cultural and other special-interest groups	0.8
Total of other transfers	*4.3*
Total transfers to persons	*21.1*

Note: Excludes unemployment insurance benefits and veterans' support. Income support total does not add due to rounding.

Source: Receiver General for Canada, *Public Accounts of Canada 1990*, vol. 1 (Ottawa: Supply and Services Canada, 1990); and C.D. Howe Institute estimates.

ture, or clawback, worth $500 million in 1991/92. Instead of reducing the transfer figures, however, this increases personal income tax revenues. As in the case of civil service pensions, but unlike most other government transfers and tax credits, the OAS is fully indexed to the Consumer Price Index, which, with demographic developments, will keep these payments — net of clawback — growing vigorously from 1991 on.

We propose that the entire Family Allowance and OAS payments system be re-examined within the context of a reform of all income taxes and transfers. The present overly generous clawback system[24] should be abandoned and all programs should be targeted to lower-income family units. Such a radical change will not be easy to implement. Two levels of government are involved in income support, and many compromises will be necessary to come up with the most efficient and politically acceptable way of delivering a guaranteed annual income. Furthermore, programs such as OAS may need a long transition period, in recognition of the number of people who have built the expectation of this money into their financial planning. However, just as the FST was studied for far too long before any action was taken to replace it, so the idea of better targeting income redistribution to those really in need is long overdue.

Residual Transfers

The federal government's "other" transfers, which amounted to more than $4 billion in 1989/90, is the category in which the most immediate savings should be made. Half of these transfers go to a wide variety of organizations and individuals, often with only a tenuous link to the kind of national objectives that one expects a central government to have.

Ottawa needs to clarify the national policy goals that are served by these expenditures. Just because payments have been made in the past for some voluntary activity, for amateur athletes or to some academics is no justification for continuing support.

An example may serve to illustrate the nature of the policy problem. In 1989, $87 million was spent on citizenship and multicultural activities. It is well known by now that Canada has a serious literacy problem. It is also agreed that the sooner an immigrant becomes proficient in one of the two official languages the sooner he or she will become a fully functioning member of Canadian society. A public program that supports languages other than English and French does not appear to fulfill any national goal. Instead, Ottawa should concentrate on programs that help immigrants to become proficient in French or English, or on literacy programs, while reducing overall expenditures.

The various transfers to persons and voluntary organizations for educational and cultural purposes amounted to almost $2 billion in 1989. There are too many programs and ministries involved to evaluate what federal objective this money is aimed at. These programs need to be rationalized within a reordered federal role in postgraduate education, retraining, and literacy (see Box 4).

Summary of Proposals on Transfers to Persons

Some broad suggestions for restraining the growth of transfers to persons — including the value of tax-related measures — are as follows:

- Replace all payments to the huge array of interest groups with a donation-matching arrangement with the private sector (individuals and corporations).
- Replace the present system of universal OAS payments and clawbacks with income-targeted payments, using family income as the criterion.
- Replace Family Allowances with enhanced child-tax credits based on family income.
- Include the payments for research, student loans, and multicultural activities in a voucher system for education and training.

Proposed Expenditure Target for Transfers to Persons

By 1995, reduce per capita spending to the 1984 level in constant dollars (see Figure 3). For 1991/92 spending would be $1.6 billion in current dollars less than targeted in the 1990 budget. By 1995, the expenditures would be $2 billion lower in current dollars than if the 1990 constant dollar level had been maintained.

Transfers to Business

Growth in constant dollar spending per capita on transfers to business in the 1980s — other than for the two-price oil system and the Petroleum Incentives Program (PIP) — was double that of the 1970s. Over the next five years, the level should be sharply reduced. In 1989/90, subsidies and capital assistance together amounted to about $7.5 billion. Of this amount, about one-fifth was in the form of capital assistance.

Capital Assistance

Even excluding PIP payments, energy-related expenditures drove this category to new heights in the 1980s, as the federal government tried to encourage the country to be more energy efficient. But as the National Energy Program ended, the Canadian Exploration and Development Incentive Program rose from its ashes until it too was doused by the 1989 budget restraint efforts. Its near relative, the Canadian Exploration Incentive Program, was just as short-lived, being terminated in 1990 along with the program known as Other Six Leases Operations. Now, Hibernia remains to keep the money flowing out.

Grants for housing construction were also significant in the 1980s (almost $1 billion in 1983), but, like some other ill-conceived incentives, were cancelled in the second half of the 1980s. It would be advisable for the govern-

Box 4

Education and Training

The largest expenditure on education by the federal government is the transfer to the provinces under Established Program Financing (EPF) — an estimated $2 billion for 1990–91 — toward their cost of postsecondary education. However, the federal government spends substantial sums on a number of other educational programs (broadly defined). It is this area that can be rationalized.

The numerous programs, which are managed by a number of different ministries, range from the Department of National Defence's training and education function to loans for students. Not only are individual programs not clearly targeted,* but it is not apparent what are the federal government's overall objectives for its involvement in education and training. Is it to increase equality of opportunity, to increase the mobility of workers, to increase their productivity, or some other reason?

About $1.5 billion was paid out in 1989 to individuals and organizations for research and so forth, including money paid out by the various research councils and funds made available to multicultural organizations.**

UI benefits also include payments to individuals who seek further training. A new Labour Force Strategy included in the 1989 reform of the UI permits up to 15 percent of the value of income maintenance benefits to be spent on training costs.

The complete cost of the Canada Student Loans Program is difficult to estimate. For example, the budgetary cost of the program in the year ended July 31, 1989, was $407 million, of which 38 percent was for claims for default. (One student in six defaults on his or her loan.) At the same date, however, there was still a total of $533 million outstanding out of the total paid by the federal government for claims for defaults since the program's inception. This amount involves an indirect interest subsidy, as does the $15 million in "excess" loans made each year.†

The federal government's roles in education should be roughly divided into the following categories:

- promoting equality of opportunity through financial support to needy persons for training and postsecondary education;
- promoting proficiency in English and French, including bilingualism where necessary;
- funding research that will further the development of human and fixed capital that is not likely to be financed by the private sector; and
- providing for education and training of the civil service and the armed forces.

The federal government should rationalize all present "education" expenditures according to these objectives, making use of private sector delivery when it is more efficient.†† The EPF transfers to the provinces could be paid directly to students in the form of education vouchers. In these ways financial savings could be achieved at the same time as money is better targeted and spent more equitably.

* See, for example, Auditor General of Canada, *Report for the Fiscal Year ended 31 March 1990* (Ottawa, 1990), paragraph 22.20.

** In addition, Ottawa paid out $104 million for vocational rehabilitation of the disabled; $200 million for official languages in education; and $551 million to Quebec for opting out of the Student Loans Program.

† See Auditor General, *Report for 1990*, pp. 695, 698–701.

†† See the Auditor General's recommendation that National Defence make greater use of the community college system (ibid., paragraphs 22.24–22.31).

ment to resist handouts for capital investment in the future.

Subsidies

In real per capita terms, subsidies — excluding payments for the two-price oil program — have been quite volatile over the past two decades. A particularly large shift upwards was evident in the 1980s, however. Subsidies to the agricultural sector — either as direct payments to farmers or indirectly through railway freight subsidies — increased temporarily in real terms in the second half of the 1970s and again after the 1981–82 recession. The later

rise was more startling and worrying. Even though it began to fall back after 1987, its per capita level in 1989 was still higher than the peak of the 1970s.

Other programs that added significantly to the total in the 1980s were the postal rate subsidy, and payments made to Canada Mortgage and Housing Corporation (CMHC) for social housing. The CBC continues to be a major recipient of subsidies — about $0.8 billion in 1989. Railways collectively receive support under many guises to subsidize operating losses and freight rates. Via Rail's subsidy has been targeted for reduction and is now about $500 million. (It is not included in the NIEA as a subsidy, however, but as negative government investment income.) Numerous other programs, through government enterprises or the private sector, cost over $600 million in 1989.

Reforming Business Transfers

The federal government needs to take a hard-nosed approach to many of these expenditures.[25] Some of those that have already been targeted for reduction — for example, VIA Rail's subsidy — should be cut even faster.

The funding of such institutions as the CBC and the Canadian Film Development Corporation needs to be re-evaluated; Canadians should decide which of these national programs or institutions they want. The federal government needs to find a national consensus on which ones Canadians are willing to pay for as they are now structured, which ones they would finance in a reduced form, and which ones they do not want to pay for through higher taxes. Willingness to bear the full cost of these institutions is likely to reflect their value to national unity.

Those programs that apparently do not serve a national goal may serve public needs at the provincial level. For example, most provincial governments have a housing program or even a separate housing agency to deliver similar programs to those presently delivered by CMHC. CMHC operations in each province could, therefore, become provincial agencies, or should be combined with existing agencies. Provinces that want to retain the programs no longer funded by the federal government should be expected to fund them by reducing other programs that are less valuable to their economies. Meanwhile, the federal government should consider auctioning off CMHC's mortgage portfolio in order to benefit from the difference between the earnings on the investment and the higher interest rates currently paid on new borrowings.

Subsidies to the agricultural sector have been large and erratic in the past decade, accounting for as much as 8 percent of the deficit. The government has not dealt with this sector responsibly, making large, unbudgeted payments for too long.

Canadian safety net programs for farmers proliferated in the 1980s in the wake of one agricultural disaster after another, and the increase in *ad hoc* rescue programs made it harder to ignore the fact that, collectively, government transfers were not distributed equitably. Furthermore, government programs were not designed to encourage dairy, livestock, and grain farmers to adjust to the global agricultural and trade realities of the 1990s.

By the end of the 1980s, it had become obvious to governments, farm producers, and processors that a new agricultural policy was overdue. Farm-support payments need to be directed at farmers' incomes, not commodities. Price-support programs to the dairy industry ($267 million in the year ended July 31, 1990) and *ad hoc* rescue programs for farmers ($1.4 billion in 1989/90 in miscellaneous subsidies such as for crop losses due to the drought in 1988) need to come to an end. The recently announced new Safety Net Program is the first step in this reform process, but will not, unfortunately, stop further demands for bailouts. It must be made clear that such solutions will not be a part of income support for this sector. This is clearly an area of overdue action by both the federal and provincial governments in the context of the deficit and the long-term viability of certain agricultural activities.

Proposed Expenditure Target for Transfers to Business

By 1995, reduce the constant dollar per capita level of spending on all transfers to private and government business to the average of the early 1980s (see Figure 3). This reduction would translate into a current dollar cut of about $1.5 billion in 1991/92 from the level targeted in the 1990 budget, and $5 billion less in 1995 than if the 1990 level had been maintained.

Summary of Stage One

An examination of historic developments in four economic categories of federal spending makes it possible to select — in the context of the federal government's appropriate policy objectives — a past level of real per capita expenditures that would be a reasonable target to reach over the next five years. The four areas together would be targeted to return to about the level of real per capita spending that prevailed just before the 1981–82 recession.

The deepest cuts ought to be in transfers to business — government and private. In current dollar terms, such payments should fall by 1995/96 to about half the size of their 1989/90 level. Transfers to persons, however, should be cut less severely — indeed, current dollar spending on such transfers could rise over the medium term. Compared with maintaining real per capita spending at its 1990 level, hitting the targets proposed in this *Commentary* would reduce current dollar spending by $10 billion by 1995/96, given our assumptions for population growth and inflation.

The advantage of the targeting strategy is the discipline that it brings to program planning. Within the targets set, each program should be audited for its effectiveness, for the appropriateness of its objective, and for the degree of its importance compared with other national programs. The federal government's response to demands for programs by particular groups must always be to decide for or against within an aggregate national context.

Stage Two: Federal-Provincial Fiscal Arrangements

The present federal-provincial fiscal arrangements have become increasingly frayed. For example, provincial experimentation to find less costly ways of delivering health care is constrained by the requirements of the *Canada Health Act*, and transfers to the provinces under the Established Program Financing (EPF) arrangement and the Canada Assistance Plan have become a millstone round the federal government's neck — as evidenced by the repeated *ad hoc* modifications to such programs over the past decade.

Several long-standing irritations between the two levels of government have erupted into the public domain in recent months, making a review of all federal-provincial programs essential. A radically new approach to shared programs and tax systems would be possible even under the existing Constitution, and could make a positive contribution to the constitutional confusion in which Canada now finds itself.

Although the federal government's piecemeal and unheralded method of shifting some of its deficit-reduction efforts to the provinces was a denial of the concept of cooperative federalism, the provinces have behaved as if the federal government's deficit and debt grew to their present gargantuan proportions through spending on activities that had nothing to do with them. While fully realizing that if the federal government needed to raise more revenues it had to raise the revenues from their residents, most of the provinces increased taxes throughout the expansion of the 1980s with no apparent sense of responsibility about keeping the lid on the burdens of their taxpayers.

The time has come to decide which level of government is the appropriate one to deliver each program and to make sure that level raises the necessary revenues. Shared-cost programs must be completely revamped, and an appropriate sharing between the federal and provincial governments and the private sector worked out.

A review of the equalization program is normally undertaken every five years and a new agreement would take effect in 1992. Since it is the practice of the federal government to review the other fiscal arrangements with the provinces at the same time, 1992 appears to be an ideal starting date for a reordered system.

Reordering Spending and Taxing Responsibilities

The current sharing of tax fields should be examined with the object of allocating some to one level of government only. Many of the programs that currently face an uncertain future at the federal level may find a new direction and vitality under provincial jurisdiction or under a federal-provincial splitting of responsibility. At the same time, some spending areas that are presently shared could be allocated to a single government. One set of tradeoffs might look like this:

- the corporate income tax, capital taxes, and payroll taxes would go to Ottawa;
- the GST would go to the provinces;
- General Welfare Assistance and student aid would become federal responsibilities;
- university and college funding would become the full responsibility of the provinces (see Box 4);
- the federal government would end its health transfers;
- the balancing item in this reallocation would be the personal income tax; some agreement would also have to be made regarding an appropriate ceiling on the personal income tax rate and how it would be split between each level.

The country is likely to realize a huge saving in the cost of administration from such a reorganization.

Four major areas of fiscal federalism call for special comment. Health, income support, and equalization are dealt with below; education was previously addressed in Box 4.

C.D. Howe Institute Commentary ® is a periodic analysis of, and commentary on, current public policy issues. *C.D. Howe Institute Commentary* supersedes *Fiscal Policy Monitor*, *Inflation Monitor*, and *Trade Monitor*.

Irene K. Ip, the author of this issue, is a Senior Policy Analyst at the Institute.

As with all Institute publications, the views expressed here are those of the author and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

Further information can be obtained by contacting: Barry A. Norris, Director of Publications, C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7 (tel.: 416-865-1904; fax: 416-865-1866).

This publication can be obtained from: Renouf Publishing Company Ltd., 1294 Algoma Road, Ottawa, Ontario K1B 3W8 (tel.: 613-741-4333; fax: 613-741-5439), or from Renouf's stores at 61 Sparks Street, Ottawa, Ontario (tel.: 613-238-8985) and 211 Yonge Street, Toronto, Ontario (tel.: 416-363-3171).

Quotation with proper credit is permissible.

$5.00; ISBN 0-88806-274-5

Health

A number of provinces have completed or are completing major studies of their health-care programs, and Quebec has already introduced a number of changes to the way it operates its health system. The time could not be better for the other provinces to change their delivery systems radically. As suggested above, the federal government should initially convert part of its cash transfer to tax points as it hands over all responsibility for this area to the provinces.

Income-Support Programs

It is time to move more boldly in the direction of phasing out all aspects of universality and replacing such programs as OAS and the Family Allowance with a gradual transition to a guaranteed annual income. The Canada Assistance Plan, too, has to be re-examined in the light of this long-term goal. It might be better for Ottawa to take over the provinces' share of

General Welfare Assistance and to convert its cash transfer under EPF for postsecondary education to an educational voucher system.

Equalization

The equalization program should be the only vehicle for dealing with regional income redistribution. The value of personal income tax points varies from province to province. The equalization, therefore, would have to be adjusted to deal with the problem of the lower value of tax points transferred to the "have-not" provinces as part of a greater devolution of responsibility for EPF.

Summary of Stage Two

The present set of arrangements serves neither efficiency nor accountability well. Moreover, there is no meeting of federal and provincial minds on the provinces' role in getting the federal debt burden turned around. A new set of arrangements could work better as well as helping to achieve the deficit targets we have laid out. There are, in addition, many areas of duplication by the two levels of government and, therefore, excessive overheads in delivery of services; these should be eliminated very quickly.

Last, but not least, the provinces need to examine their own expenditures in a similar framework, reassessing their priorities in the light of their citizens' combined federal-provincial-local tax burdens. They will have to experiment, as some have begun tentatively to do, with new ways of delivering such major programs as health, welfare, and education to achieve their policy goals more efficiently and equitably. The devolution of part of the federal deficit should thus be accompanied by joint federal-provincial restraint in spending and without increasing the tax burden.

Conclusion

In the 1980s, fiscal policy in Canada operated with little regard for its impact on the economic cycle and with no effort at federal-provincial coordination. At the federal level, debt-service costs — swollen by a combination of chronic deficits and high real interest rates — and too many *ad hoc* programs overwhelmed inadequate efforts to bring program spending down to a more sustainable level. Promises of reduced income tax rates were forgotten, temporary surtaxes became permanent and larger, and lucrative provincial revenue sources were further invaded in the desperate attempt to prevent the debt burden from heading toward the stratosphere. Meanwhile, in too many provinces, expenditures were allowed to grow unchecked, financed by buoyant revenues and tax increases. By behaving very provincially, provincial governments in the 1980s made the federal government's job of getting control of its debt burden more difficult.

The irresponsible bent of fiscal policy during the 1980s at both levels of government has left the country without its customary cushion against an economic slump. Since the first concern of finance ministers must now be to prevent deficits from ballooning, fiscal policy has had to move into a procyclical mode, which risks making the recession worse and delaying recovery. In order to improve the federal government's stabilization role in the future, UI premiums should be set solely by a formula that would increase the cyclical nature of the UI account balance.

Canadian governments really have no other choice than to try to keep the lid on deficits and debt ratios, even during the present tough economic climate. This effort should not be a piecemeal exercise, but part of a carefully planned strategy to get the debt burden onto a meaningful downward track once expansion gets going. The public sector now eats up a share of domestic saving that is too large, and the country faces a dangerously high tax burden. The long-term harm these phenomena are doing to the Canadian economy now means that deficit control through expenditure restraint has to take precedence over trying to jump-start the economy through expansionary fiscal action.

A number of factors, which have already been set in motion, are expected to combine to reduce the federal deficit substantially in fiscal year 1992/93. But those very elements that can help the federal government to gain control of its finances in the short term could be the Achilles' heel of medium-term policy if the improvement the Institute foresees in 1992/93 encourages the government to loosen its purse strings and set off a new round of increases in expenditure, deficits, debt, and, finally, taxes. Therefore, once again we urge the federal government to adopt a medium-term framework of expenditure restraint — one that the provinces could easily imitate.

If the federal government were to use real per capita spending targets, it could plan much of its spending in relation to the easily predictable growth of the population, rather than to the growth of the economy; in this way, it could avoid the tendency for program spending to mushroom during expansions.

Ottawa should rationalize its programs according to clearly defined policy goals, which should help it to weed out those programs that have anachronistic objectives, that are of low priority, or that are more appropriately delivered by another level of government.

If the federal government's spending is not ordered according to objectives and priorities, its annual medium-term plans to reverse the net debt-to-GDP ratio will probably continue to fail — since most programs now in place are driven by such factors as inflation, economic growth, and demographics, which more or less ensure that they grow as fast or faster than revenues when left alone. To deal with this problem, the government has often resorted to such devices as fiddling with indexation factors, temporary capping, accelerating tax remittances, or taxing back some expenditures. These are techniques that minimize the political embarrassment of axing or cutting back the scope of programs — which would risk offending special-interest groups — but they avoid getting to the root of the deficit dilemma.

In 1992/93, with a plan of program restraint in operation, federal and provincial governments should embark on a new fiscal relationship, one that takes into account the need for a federal-provincial partnership in the matter of the public debt; the appropriate delivery of programs (by level of government or by the private sector); the appropriate sharing of program costs (by level of government and private sector beneficiaries); and the changing needs and aspirations of Canadians. It will not be easy for the federal and provincial governments to agree on the reallocation of responsibilities for programs, raising revenues, and reducing deficits. If they shirk this task, however, the constitutional negotiations will be all the more difficult.

Notes

1 For example, Ontario's "smart" move in replacing its health premium with a payroll tax forced the federal government to pay a large proportion through the federal civil service located in that province and to lose some corporate income tax because the business expense of the tax was so much larger than the premium.

2 In its *Policy Review and Outlook, 1990*, the Institute advocated that: support for interest, advocacy, and cultural groups be cut; transfers to business be reduced; capital construction be restricted to maintenance; airports be put on a self-sustaining footing; the efficiency of the civil service be increased; and an early start be made on renegotiating federal-provincial shared-cost programs. See Irene K. Ip and William B.P. Robson, "Fiscal Policy," in *Getting It Right*, Policy Review and Outlook, 1990, edited by Thomas E. Kierans (Toronto: C.D. Howe Institute, 1990), pp. 108–112.

3 Department of Finance, *The Fiscal Plan 1989* (Ottawa, 1989), p. 31.

4 Although the employer-employee premiums are set to pay for the internal costs of operating the UI program — administrative costs and debt-service charges when the UI account is in deficit — as well as the external costs (the benefits), it is the difference between the benefits paid and the revenue from premiums that is the measure of the UI plan's impact on the economy.

5 The finance minister may, however, exercise some control over the UI account balance by keeping the payments for retraining below the limit that the legislation allows.

6 This calculation uses NIEA data for the whole public sector, including the Canada Pension Plan and the Quebec Pension Plan.

7 The GST is supposed to be refundable on tourists' expenditures, but experiences of countries that have a value-added tax suggest that most visitors will be unable to take advantage of this provision.

8 See, for example, Robert J. Barro, *A Cross-Country Study of Growth, Saving, and Government*, NBER Working Paper 2855 (Cambridge, Mass.: National Bureau of Economic Research, 1989), p. 6.

9 Department of Finance, *The Fiscal Plan 1986* (Ottawa, 1986), p. 68.

10 It is, of course, appropriate to adjust the debt-service charges to eliminate the component that is paid to bondholders as compensation for the inflationary erosion of their principal. With the decline in inflation that we expect to see in the 1990s, real and nominal net interest payments will begin to converge dramatically (see Ip and Robson, "Fiscal Policy," pp. 99, 115, 117).

11 As measured by Statistics Canada, prices of government-purchased goods and services rose more rapidly than the implicit GDP price index from the early 1950s to the mid-1980s and more slowly thereafter. Program costs and the quantity of programs are two separate issues.

12 There is also no economic rationale for government expenditures to keep pace with GDP growth.

13 Department of Finance, *The Fiscal Plan 1986*, p. 23.

14 Ibid. For example, the government predicted in 1986 that the ratio of program expenditures to GNP would decline to the 1969/70 level by 1990/91. As it happened, the level of GNP that was assumed in these predictions is now estimated to have been about 2 percent lower than the actual 1990 level. The same ratio would, therefore, justify a level of program spending about $2 billion higher. We estimate that the level will be about $4 billion more than that plan.

15 The government makes a commitment to the United Nations to deliver support to the Third World measured as a target percentage of Canada's GDP (currently to be 0.47 percent by 1994/95).

16 The data used are Statistics Canada's NIEA measures, with some adjustments. For example, the payments by the federal government to cover the cost of indexation of retired government employees' pensions are included in budgetary expenditures whereas the annuities that are paid out of the superannuation funds are not. Since both are included in the NIEA, the latter payments have been deducted from the NIEA transfers to persons. The capital consumption allowance, an imputed item in the NIEA measure of current goods and services, has been deducted from that measure.

17 In the constant dollar per capita analysis, the Petroleum Compensation and Petroleum Incentive Programs were ignored since they operated in tandem with earmarked energy taxes.

18 See Richard M. Bird and David K. Foot, "Bureaucratic Growth in Canada: Myths and Realities," in *The Public Evaluation of Government Spending*, edited by G. Bruce Doern and Allan M. Maslove (Halifax: Institute for Research on Public Policy, 1979), pp. 121–148.

19 Auditor General of Canada, *Report for the Fiscal Year Ended 31 March 1990* (Ottawa, 1990), pp. 561–566.

20 Legislation to reform the public service pension plan was tabled in 1978 and again in 1986, but both bills died on the order paper because elections were called. Bill C-33, tabled in December 1986, made a number of proposals about pension liabilities incurred after passage of the legislation. For example, civil servants would have had to share the cost of indexation of pensions with the government. Instead of guaranteeing full indexation of pensions to the CPI, indexation would have been based on fund earnings and the rate of return of the fund would have been based on the performance of a group of private sector pension plans.

21 For example, the final costs of four forestry centers were up to nine times the original estimates (Auditor General, *Report for 1990*, paragraph 11.4).

22 If it included the value of refundable tax credits and nonrefundable credits such as those for child care, the increase would be considerably greater.

23 Gross payments were $38.8 billion, but $1.8 billion in annuities to retired civil servants paid out of their superannuation fund has been excluded since it is not part of budgetary expenditures.

24 The clawback system does not treat recipients with similar incomes equally. The tax treaty with the United States does not permit Canada to tax back any of the OAS from Canadians living in that country.

25 Because of the urgency of reducing the debt burden, the federal government should not have promised to support the Toronto Opera House at this time.

Recent C.D. Howe Institute Publications

Doern, G. Bruce, and Bryne B. Purchase (eds.). *Canada at Risk? Canadian Public Policy in the 1990s*, Policy Study 13 (January 1991). ISBN 0-88806-259-1. 255 pp.; $14.95.

Laidler, David E.W., and William B.P. Robson. *Money Talks — Let's Listen*, C.D. Howe Institute Commentary 26 (January 1991). ISBN 0-88806-273-7. 16 pp.; $5.00.

Howitt, Peter. *A Skeptic's Guide to Canadian Monetary Policy*, C.D. Howe Institute Commentary 25 (December 1990). ISBN 0-88806-271-0. 16 pp.; $5.00.

Wonnacott, Ronald J. *The Canadian-U.S. Experience in Auto Trade since 1965: Its Relevance for Free Trade Negotiations with Mexico*, C.D. Howe Institute Commentary 24 (December 1990). ISBN 0-88806-270-2. 8 pp.; $5.00.

Doern, G. Bruce (ed.). *Getting It Green: Case Studies in Canadian Environmental Regulation*, Policy Study 12 (November 1990). ISBN 0-88806-269-9. 214 pp.; $14.95.

Trebilcock, Michael J., and Robert C. York (eds.). *Fair Exchange: Reforming Trade Remedy Laws*, Policy Study 11 (November 1990). ISBN 0-88806-267-2. 303 pp.; $14.95.

Wonnacott, Ronald J. *U.S. Hub-and-Spoke Bilaterals and the Multilateral Trading System*, C.D. Howe Institute Commentary 23 (October 1990). ISBN 0-88806-268-0. 24 pp.; $5.00.

Laidler, David E.W. *Money after Meech*, C.D. Howe Institute Commentary 22 (September 1990). ISBN 0-88806-266-4. 8 pp.; $5.00.

Wonnacott, Ronald J. *Canada and the U.S.-Mexico Free Trade Negotiations*, C.D. Howe Institute Commentary 21 (September 1990). ISBN 0-88806-265-6. 8 pp.; $5.00.

Lipsey, Richard G. *Canada at the U.S.-Mexico Free Trade Dance: Wallflower or Partner?*, C.D. Howe Institute Commentary 20 (August 1990). ISBN 0-88806-264-8. 16 pp.; $5.00.

York, Robert C. (ed.). *Taking Aim: The Debate on Zero Inflation*, Policy Study 10 (August 1990). ISBN 0-88806-256-7. 263 pp.; $14.95.

Robson, William B.P. *Not-So-Fine Tuning: Bank of Canada Policy and Inflation since 1986*, Inflation Monitor 5 (August 1990). ISBN 0-88806-263-X. 12 pp.; $5.00.

Doern, G. Bruce. *Canadian Environmental Policy: Why Process Is Almost Everything*, C.D. Howe Institute Commentary 19 (July 1990). ISBN 0-88806-262-1. 12 pp.; $5.00.

Laidler, David E.W., and William B.P. Robson, *The Fix is Out: A Defense of the Floating Canadian Dollar*, C.D. Howe Institute Commentary 18 (July 1990). ISBN 0-88806-261-3. 16 pp.; $5.00.

Doern, G. Bruce. *The Federal Green Plan: Assessing the "Prequel"*, C.D. Howe Institute Commentary 17 (June 1990). ISBN 0-88806-260-5. 8 pp.; $5.00.

Laidler, David E.W., and William B.P. Robson. *Mainly Money: The Cause of Canadian Inflation*, Inflation Monitor 4 (May 1990). ISBN 0-88806-258-3. 16 pp.; $5.00.

Doern, G. Bruce (ed.). *The Environmental Imperative: Market Approaches to the Greening of Canada*, Policy Study 9 (April 1990). ISBN 0-88806-255-9. 140 pp.; $15.00.

Lipsey, Richard G. (ed.). *Zero Inflation: The Goal of Price Stability*, Policy Study 8 (April 1990). ISBN 0-88806-253-2. 165 pp.; $15.00.

Robson, William B.P. (ed.). *Problems and Priorities for the 1990 Federal Budget: A Survey of Views from a C.D. Howe Institute Pre-Budget Workshop, January 26, 1990*, Fiscal Policy Monitor 4 (February 1990). ISBN 0-88806-254-0. 12 pp.; $5.00.

Kierans, Thomas E. (ed.). *Getting It Right*, Policy Review and Outlook, 1990 (January 1990). ISBN 0-88806-252-4. 161 pp.; $15.00.

Brown, Robert D. *The Other Shoe — The GST: Stage Two of Tax Reform*, Fiscal Policy Monitor 3 (November 1989). ISBN 0-88806-251-6. 16 pp.; $5.00.

Lipset, Seymour Martin. *Continental Divide: The Values and Institutions of the United States and Canada*, CAC 59 (October 1989). Out of print (a trade edition has been published by Routledge).